DOW THEORY LETTERS INC.

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THE MARKET: As far as most Wall Streeters are concerned, 1965 will undoubtedly go down as "a wild year" for the market. But my bet is that 1966 is going to be even wilder and woolier. Let's look at the current situation. As far as Dow's Theory is concerned, the primary trend of the market remains bullish. The bull trend was reconfirmed in October and again in December (as Industrials and Rails pushed to new bull market highs). Against this, 11.8 million shorts (the greatest number in Exchange history) are betting that a bear market is "just around the corner." The fact is that the short sellers do have some powerful arguments to back up their stance, but the writer is also reminded of the words of the great Dow Theorist, William P. Hamilton: "It would be possible to offer endless instances of people who lost money in Wall Street because they were right too soon."

There is no doubt but that opinion is sharply divided among market analysts and even among economists. Money is tight and getting tighter, the U. S. is fighting a very expensive war, industry is straining to produce enough for soldier and civilian alike, borrowing is at record levels, all segments of industry are booming. A large majority of the population is of the opinion that war automatically guarantees both prosperity and inflation. These are the out-and-out bulls. But many seasoned observers believe that the market is in for "roller coaster action" as peace feelers and escalation threats alternately wrack a war-sensitive Wall Street. Still others feel that the spectre of higher taxes and rising interest rates will squeeze off the boom. For instance, listen to this quote from the recently bullish but now bearish Janeway Report (by economist Eliot Janeway): "The prospects would be bearish enough if rates of interest were rising while rates of return were falling in peacetime. In time of war, such a squeeze is intolerable. Whatever else the U. S. may be able to afford, it cannot afford to finance a war at an interest rate of 5% and a profit rate of 10% minus."

In this writer's opinion, what we are going to see during the first part of 1966 is a titanic high-volume struggle between the bulls and the bears. The volume will be indicative of the intensity and depth of the difference of opinion on Wall Street. Along these lines, let's examine some recent history. In the final seven months of 1965 (May to date) the investment-grade D-J Industrial Average produced a net gain of only 2% accompanied by the greatest volume of transactions in Exchange history. This occurred while the short interest was building up to historic proportions and while a schizophrenic market saw "war babies" double and triple and as G.M., Telephone and U. S. Steel moved sideways. This type of market is never attractive to serious investors — the more so when it occurs in the face of the fattest bond yields in a generation.

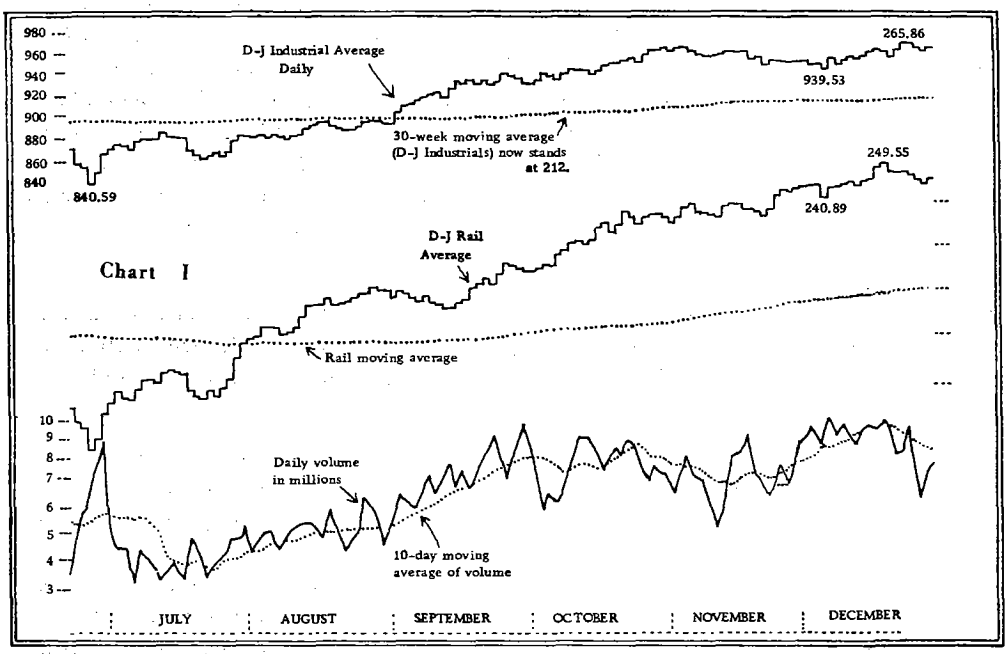
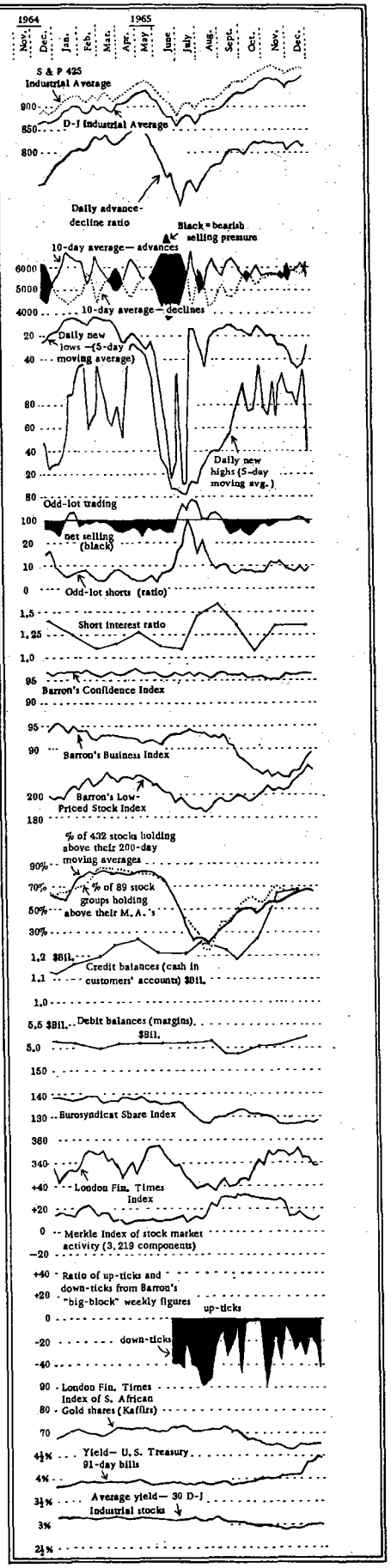


Chart I


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average—advances
10-day average—declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
Net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield—U.S. Treasury 91-day bills
Average yield—30 D-J Industrial stocks

Therefore, my best guess for 1966 is that the market will continue highly speculative and that volume will run even higher than 1965. But some time during 1966 we are going to see a massive cave-in as the great bull market "churns," runs out of technical strength and finally collapses.

* *

Chart 1 shows the significant levels established by the Averages over the past few months. These levels are the December all-time highs of 965.88 (Industrials) and 249.55 (Rails) and the earlier December lows of 939.53 and 240.89. While it would not be unusual to see the highs bettered in the period following Christmas, it would be an absolute rarity to see the lows violated. In the entire history of the Averages going back to 1897, there has never been an outstandingly weak performance in the period between Christmas and New Years. The only weakness worth mentioning occurred in the Industrial Average alone in 1926.

For the near-term, suffice it to say that all trends are bullish. A reconfirmation of the bull trend will occur if both Averages better their December highs. Conversely, the first indication of trouble would be signalled by a joint breaking of the 939.53 and 240.89 levels (i.e., the December lows). Past history suggests that the December lows are of almost "barometric" importance. If 1966 is to be a good year then precedent suggests that the December lows should hold during early 1966. Conversely, a breaking of the December lows by both Averages during the first quarter of '66 would appear ominous.

SUNDRY COMMENTS: I received many letters regarding last week's chart of the discount rate and the cost of interest since 1928. Few people are aware that the interest on the U.S. national debt is now one of the largest items in the entire budget, ranking second only to national defense. The following will give readers an idea of how the interest on the debt is compounding. Due to higher interest rates and expanding deficits, the annual interest on the national debt in the five years from June, 1961 to June, 1966 will have risen by $3 billions. Next year the interest on the debt will be $13 billions. For comparison purposes, it is worth noting that the entire national debt in 1929 was $16 billions.

Within the next year approximately $56 billions in Treasury bills and approximately $38 billions in notes and bonds will be up for refinancing. This total of around $95 billions will all be refinanced at the new rising interest rates (as discussed in the last Letter). The First National Bank of Dallas notes that the computed interest rate on the total Federal debt in September was 3.68%, highest in 35 years! It is up from an all-time low of 1.92% in 1944. In other words, the whole current debt picture is one of compound interest and deficits in action. Is it any wonder that McNamara is announcing selected defense cut-backs while Fowler is talking about increasing the income tax and rumours are popping up regarding reinstatement of the excise tax?

* * * *

The Federal Reserve Board is composed of Chairman Martin and six other members. Among the six members, there are three "liberals" and three "conservatives." But all eyes will be on the Board in January when C. Balderson (a "tight money" man) retires. If President Johnson picks an "easy money" member to replace Balderson, the Board will then have four soft money advocates and Martin will be easily outvoted. In this case, Martin could resign. Many liberals believe Martin's resignation would constitute a victory for LBJ. However, Martin is viewed as the bastion of the dollar by European central bankers and these gentlemen would take Martin's resignation as a sign of danger for the dollar. Conclusion: don't bet that LBJ wants to "pack" the Fed. LBJ's Board appointment in January will tell us a great deal regarding how seriously he takes the decline of the dollar and how seriously he takes the views of foreign central bankers (America's creditors).

* * * *

I spent the afternoon of December 23 alone in the slums of Tiajuana, Mexico. I recommend that day and that area to all who can get there next year. It's a sight you won't soon forget — and one which will make you think. Each December 23 the produce merchants of Tiajuana pass out 10 pound bags of vegetables and fruit to the poor. I've seen the poor of Naples during World War II, I've seen the poverty-striken Arabs of Algiers and I've seen the peasants of Brazil. But I've never seen a sadder sight that the one in Mexico, and this within 10 miles of the U. S. border at Christmas, 1965. From morning to night thousands of Mexicans line up for the Christmas packages (worth perhaps 50¢ a piece). Whole families, wrinkled grandparents, fathers, sad-eyed mothers, tattered children, all slowly filing past the food trucks while a harried group of attendants shout "Andale, andale," move along. Many of the families eat the vegetables raw right in the streets. They don't even bother taking them home. I don't know if there is a moral in all this. "Count your blessings" seems too pat and simple.

The Composite Chart (Page 1) shows an interesting disparity cropping up between the Dow Jones and the Standard & Poor Industrial Averages. It is of interest to note that the high on the S & P Industrials was struck on November 15 at 98.55 (the S & P 500 Average touched its high on the same day), but both S & P components failed to follow the Dow to new highs in December. This highlights the bearish disparity between the two indices and suggests a correction ahead. Many market technicians construct a "disparity index" by dividing the daily close of the S & P 500 by the daily DJI close. The resultant figures are charted daily. The current disparity has been building since August and is very persistent.

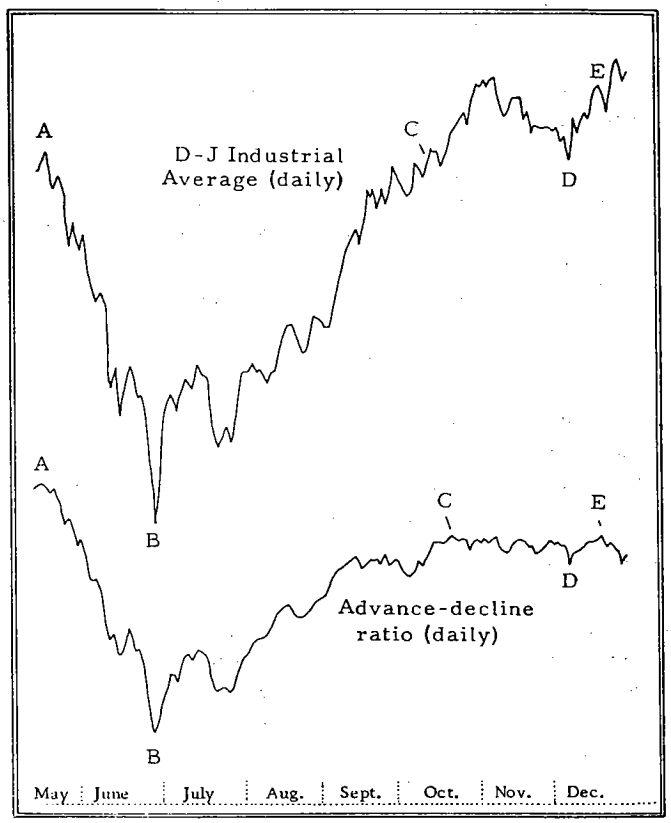
The most bullish technical indications in this market stem from the record 11.8 million shorts (December figures) and the 1.36 short interest ratio. We should realize that on any day when volume recedes to under 6 million shares the short ratio rises to around 2, a very bullish level. Also bullish is the new high in credit balances which suggests that the public is still bearish and continuing to build up cash in its brokerage accounts. Barron's tabulations of big-block "ticks" shows minus 42 for the period ending December 22, suggesting big money distribution. On December 28 the S. African gold index closed at 65.8, highest level in two months and the first important upward zig-zag in this index since the August, 1965 peak (see gold section in this Letter). The adverse spread between the yields on the Dow and the Treasury bills continues. Conclusion: my reading of the whole picture is that the technical factors are generally bullish ones while the fundamental factors are decidedly less so. In all I feel it is a time for caution, heavy cash holdings and a good hedge in gold shares.

PRICE AND BREADTH: In a bull movement it is normal over any appreciable length of time for prices to rise and for more issues to advance than decline. This may be reflected by (1) a rising trend in the Averages, (2) a rising trend in the advance-decline ratio (for a discussion of the composition of the A-D ratio please refer to the "Technical Studies" booklet which has been sent to all subscribers).

The relationship between the D-J Industrial Average and the A-D ratio is an extremely important one, and it can be used in two ways to gauge the progress of a bull move. (1) The movement is deemed strong and healthy as long as both indicators (i.e., the Average and the ratio) are advancing together and as long as both indicators are confirming each other by bettering successive points. (2) Caution is warranted whenever one indicator refuses to confirm the upside penetration of the other. Extreme caution is advisable whenever a series of non-confirmation or a continuous divergence appears. As a rule, most divergences will be ultimately resolved in the direction of the A-D ratio. Thus, during an extended advance it is the A-D ratio which usually weakens first (even though the Industrial Average may continue higher for many weeks). It is this lagging or persistent divergence by the A-D ratio which tells us

that the advance is "on borrowed time."

With all this in mind, it might be worthwhile to examine the relationship of price and breadth since May, 1965 (see chart). In mid-May (point A on chart) the two indicators recorded their last confirmed highs. From mid-May to late-June, an extraordinary reaction succeeded in wiping out the entire first quarter's gain in both the A-D ratio and the Industrial Average (A-B on chart). A recovery set in at B, and Industrials rapidly regained their lost ground. On October 11 (C) Industrials hurdled their May peak of 939.62, thereby rising into new all-time high ground. Although the A-D ratio had also been rising steadily, it did not succeed in bettering its May peak at A.



On October 18 (C) the A-D ratio established a peak on the recovery from the June low. A period of irregularity followed with both indicators retreating. The lows were struck on December 4 (D) simultaneously with the announcement of the Reserve Board's raising of the discount rate. A violent rally ensued, and on December 17 (E) the A-D ratio bettered its entire fall range. This was immediately confirmed by Industrials which pushed to a record high. Following E Industrials spurted to another all-time high of 965.86 (December 22) but in the face of this latest bit of Industrials exuberance the A-D ratio declined. By December 28 the A-D ratio was back at its December low at D again.

The points to note are these: the A-D ratio has not yet bettered its May high at A. This is long range consideration, but it is nevertheless a definite technical problem. Of nearer term and more immediate interest is the non-confirmation of the December 22 Industrial high by the A-D ratio. In order to avoid near-term trouble it will be necessary for breadth to produce enough strength to carry the A-D ratio above the recent December 17 high at E. This situation will be followed closely in forthcoming Letters.

THOUGHT OF THE WEEK: In a speech before the National Association of Mutual Savings Banks economist S. B. Klansman suggested in jest that the Magic Fives of '59 might give way to the Magic Sixes of '66. But Business Week (December 25) was not joking when it included this little squib in its "Wall Street Talks" column.

> Bond men are beginning to scent **another "magic five"** in the air. The "magic fives" were Treasury notes issued in 1959 with a maturity of four years, 9 months, that were priced to yield 5%. Investors, both big and little, gobbled them up. With demand for funds rising from both business and government, Treasury may have to come up with another such issue next year.

GOLD SHARES: Interest in gold shares is now noticeably low. Nevertheless, the fundamentals warranting purchase and retention of gold shares have, in this writer's opinion, been improving. Here are some of the fundamentals. (1) The U. S. balance of payments will probably deteriorate badly in the fourth quarter and during 1966. Our exports have been sagging, our imports have been rising, and U. S. spending is mounting to record levels. (2) Foreign claims against U. S. gold are rising as the U. S. money supply surges (due to "printing press" activities on the part of the Fed). Thus the rise in the discount rate will accomplish far less than was thought (foreign nations are already pushing up their own rates to compensate for our rate boost), but it is the flood of dollars which impairs any efforts to improve the balance of payments. (3) The gold reserve ratio (see last Letter) has been dropping rapidly, and this will serve to focus attention on our gold problem. (4) Foreign nations, particularly common market nations, have been raising their gold reserves, and this gives them a "built-in" bias in favor of gold. This gold-bias has all but erased any interest they may have shown towards U. S. "paper money" plans for increasing gold reserves. (5) DeGaulle's re-election puts teeth in the Common Market's resistance to a "new gold-lowered currency." (6) The Vietnam war, as and if it continues, is putting an unbearable strain on the dollar. This will necessitate higher taxes or spending cutbacks or both. However, my own observation is that the spending is always bigger than anticipated and the cutbacks are always smaller. (7) From the Harry Schultz Letter (P. O. Box 619, Beverly Hills, Calif.): "Total private hoards of gold rose in the year ending 10/31/64 by more than 43%. They are at least $16.8 billions, rising for the first time above the level of U. S. Government holdings! Thus 29% of all the world's gold is now in non-Government hands."

From the timing standpoint, the gold (particularly the S. African golds) are also interesting. (1) Britain did not devalue, and consequently most of 1965's gold speculators dumped their shares. Since they were playing for a specific dramatic event, not for fundamentals, they became discouraged and gold shares subsequently drifted lower. (2) The Rhodesian crisis has served to reawaken fears about the "African tinderbox." South African shares were consequently pushed even lower amid fear selling. (3) Secretary of the Treasury Fowler's many measures seemed to be working, and many began actually to believe that the U. S. had solved its gold problem. Mr. Fowler was aided by a great blast of uninformed propaganda from the press.

Thus, while the fundamentals were improving for gold shares, a series of events drove them to what this writer believes to be bargain levels. Conclusion: I believe golds are a buy, and I suggest that those who do not now have the suggested 10 to 15% of assets in gold utilize this period to accumulate gold shares. Recommended gold shares in Canada are Dome, Campbell Red Lake, Cochenour Willans. Recommended shares in S. Africa are Free State Geduld, President Brand, Western Areas and Western Deep Levels.

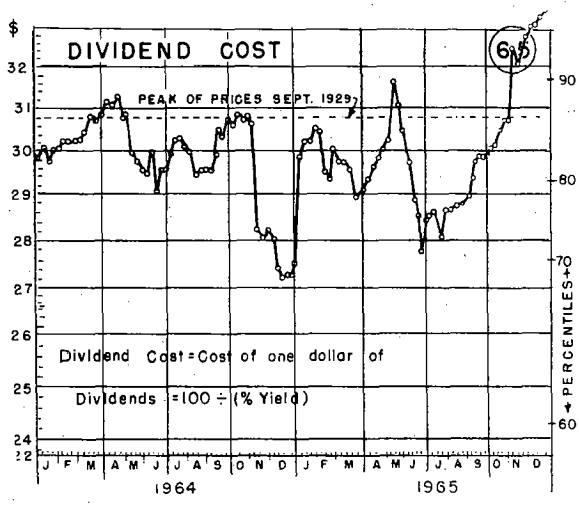
I want to suggest Free State Geduld Mines in particular as a stock for income (while hedging against a possible increase in the price for gold). Free State is one of the lowest cost gold producers in the world; it has extensive reserves. In the year ending September 30 Free State's earnings rose 5.5% to $2.07 per share. The dividend was raised from $1.33 to $1.52. Allowing for the 7½% tax on S. African dividends, this means that Free State provides a yield of 7.3% to Americans who buy the stock at the current price of 19¼. Furthermore, Free State owns 50% of Freddies Consolidated gold mine and income from Freddies could mean another dividend boost in 1966. Free State may be purchased via American Depository Receipts.

THE WAR: Undoubtedly the biggest question on the market's mind is the war in Vietnam. How will the market act if the war continues? What will the market do if the war is ended? These are critical questions. My own opinion is that the war is bearish for the economy and for the market. I further believe that if the war is ended the public and Wall Street might react very bullishly. In that case we could get an upside "explosion" as the shorts are finally run out. Following such a short-term to intermediate surge, I would expect the entire 1949-1966(?) bull structure to top out and a major bear market to begin.

The U. S. has temporarily halted its massive air attacks. Rumors are flying regarding possible peace negotiations. Mr. Harriman is in Poland meeting with Chinese envoys. The Pope is supposed to be conducting secret talks, Vice President Humphrey is running about the globe. Again my opinion: Johnson is desperate for peace, fears he is caught in a gathering fiasco. Meanwhile, Russia is worried lest China capture control of world communism, but Russia does not want to break with the U. S. over Vietnam. China would lose prestige if the war was settled without her approval. China must ask: is Ho Chi Minh willing to fight on even though Vietnam is sure to be leveled — or will Ho decide that the U. S. will not get out and that now is the time to negotiate? Red China does not want real peace, and she must know that "small scale" wars are the perfect way to bleed the U. S. dry. But the Chinese have to decide whether Ho is weakening. If he is then China wants to be the one to give the "go ahead" on peace talks (this would put her in the spotlight as the leader of world communism instead of Russia).

Studious observers all over the world are now holding their breaths. They sense that it's a case of settle now "or else." U. S. opponents to the Vietnam bombing have been saying that we should hold off bombing for a period of four or five weeks as this will allow Ho to formulate negotiation plans. The bombing has been halted: this is the "lay off" period, the American peace offensive. The Chinese and the Vietnamese must sense how extremely anxious the Administration is to end the war now. If they turn the U. S. down here, we lose face. We also greatly increase our "moral justification" for stepping up the war. It's peace in the next month or "watch out!"

STOCKS: As 1966 is ushered in, the market has become "a crap shoot." A bull market has been "locked in" by a war that may end at any time or one that may intensify. A violently speculative bull market has run head on into the realities of stepped up war or peace. Investment grade stocks are now selling at rich multiples of record earnings. As proof of this statement I have included a chart received today from Merrill Analysis (Box 228, Chapaqua, N.Y.) showing the cost of a dollar of Dow dividends. The chart is self-explanatory and shows the cost of a dollar of dividends rising over $33. In the face of this, I can only say that today's high yielding Treasury bills are more worthy of investor's funds than are the very high-priced Dow stocks.


$
DIVIDEND COST
PEAK OF PRICES SEPT. 1929
Dividend Cost = Cost of one dollar of
Dividends = 100 ÷ (% Yield)
PERCENTILES
J F M A M J J A S O N D J F M A M J J A S O N D
1964
1965

ANNOUNCEMENT: Enclosed with this mailing is a dated sample copy of a new service, Economic Trends. This is a service which I have wanted to start for many years, and it is finally off the ground. The indicators shown in the new service cover the whole stock market and economic scene, and a knowledge of these indices should be of tremendous help to all investors and businessmen. Furthermore, the period ahead should be a particularly exciting time to follow these indicators, for I believe that the year 1966 is fated to usher in an era of dramatic and unexpected change. I have also taken the liberty of enclosing the advertising flyer for Economic Trends (together with the subscription coupon); the advertising may be a bit blatant but I am sure my subscribers can take it. Here is a SPECIAL OFFER: To all subscribers I offer a one year subscription to Economic Trends for the special price (Airmailed) of $20. This offer will be in effect until January 20. I (blushingly) believe that this offer is a bargain, and will be well worth the price in knowledge gained.

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In closing this Letter I want to wish all my subscribers a most happy and healthy 1966.